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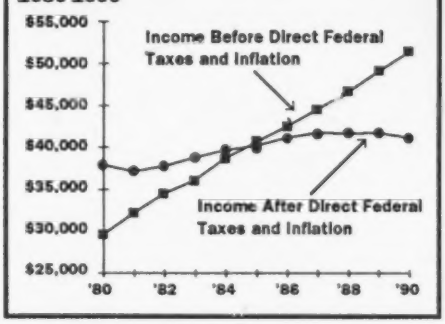
Tax Features

U.S. Family's Real Income To Drop in 1990 Due to Higher Taxes and Inflation

The one-two punch of rising inflation and direct federal taxes will reduce the purchasing power of the U.S. family's income in 1990. A typical family — a household with two earners employed full-time year round with two dependent children — will experience a net decrease in real income of $614 in 1990 after adjusting for direct federal taxes (see figure above). This is the most substantial decline

See Median Family Income on page 5

Median Family Income Before and After Direct Federal Taxes and Inflation
1980-1990



William S. Kanaga to Receive Distinguished Service Award At 1990 Annual Dinner

William S. Kanaga

William S. Kanaga, former chairman and chief executive officer of Arthur Young & Co., will receive the Foundation's Distinguished Service Award for the Private Sector. Senator Bob Packwood is the public sector award recipient. The occasion will be the Foundation's 53rd annual dinner on December 5. For details on attending the dinner and the 42nd annual national conference beforehand, see page 7.

FRONT BURNER

Budget Plays Shell Game with American People

Senator William Roth

I once heard that the definition of the Eiffel Tower is the Empire State Building after taxes. I'm afraid that this definition will take on new meaning with the recently approved budget package. Not only has Congress further stripped financial wherewithal from the American taxpayer, but it is one more step toward taking a strong economy and turning it into a shell.

I voted against the budget because it meets virtually none of the criteria America needs to meet its future in an increasingly competitive world. Some tried to sell the package as a bipartisan success that provides $490 billion of deficit reduction over the next five years. But, what we really have is a package that includes $200 billion in new revenue made up of tax increases, user fees and increased Medicare premiums. The rest is $70 billion in domestic spending reductions, $180 billion in defense savings and $64 billion in savings on interest on the national debt. This does not include the increased spending, tax breaks, and income redistribution, all of which detract from deficit reduction.

A closer look at the budget, especially the tax components, illustrates the real burden it will have on the American public and our economy. Proponents argue that the net tax figure is $137 billion, but in reality total tax increases will hit $164 billion. The $27 billion difference includes tax breaks and income redistribution.

See Roth on page 2

Senator William Roth, Republican from Delaware, serves on the Senate Committee on Finance.

The opinions expressed in the Front Burner are not necessarily those of the Tax Foundation. Editorial replies are encouraged.

Tax Foundation

IN THIS ISSUE

Median Family Income Falls	1
"Front Burner"	1
Kanaga to Receive Award	1
U.S. Transfer Pricing Policy	3
New Budget's State-by-State Impact	4
President's Message	5
Viewpoint	6
Annual Dinner and Conference	7
West Coast Member Briefings	8

Roth from page 1

The increase in Health Insurance wage base, the phase-out of personal exemptions, and the reduction of itemized deductions are only three of 26 different tax increases in the budget — many of which will hit the middle class right on the chin. While the taxes in this proposal are for certain, the spending reductions aren't.

Only $70 billion of this package are real reductions — reductions in Medicare, Federal Employee Retirement, Veterans programs, student loans and agriculture. New revenue increases outpace entitlement savings three to one. Under this so-called deficit reduction plan, total government spending will be $100 billion higher in 1991 than it was in 1990.

"Not only has Congress further stripped financial wherewithal from the American taxpayer, but it is one more step toward taking a strong economy and turning it into a shell."

Even during this time of austerity, this legislation builds in increasing spending for discretionary programs. If there were guarantees that these increases were necessary, it would be one thing. Unfortunately, these guarantees don't exist. We are already hearing of discretionary funds to be used for renovating the home of Lawrence Welk, studying the potential for a national bicycle policy, as well as looking for a place to build a new Congressional staff gym. In other words, Congress not only passed the buck — but spent it.

"[There are] 26 different tax increases in the budget — many of which will hit the middle class right on the chin."

Concerning defense cuts, the $180 billion of this package counted as defense savings may very well be real, but is not the result of the budget negotiations. It represents a windfall due to the communist meltdown. And, like a windfall, this $180 billion is fortunate at best and illusory at worst.

"We are already hearing of discretionary funds to be used for renovating the home of Lawrence Welk, studying the potential for a national bicycle policy, as well as looking for a place to build a new Congressional staff gym. In other words, Congress not only passed the buck — but spent it."

Another component of the package is the $64 billion in reduced interest payments on the national debt. This figure is based on extremely optimistic interest rate assumptions and has very little to do with the hard choices Congress must make to get the deficit under control.

Some would argue that the deficit reductions are for real. But even the proponents of the package admit that Gramm-Rudman is only advisory during the first three years — with no bite to limit spending. The so-called spending caps intended to monitor spending through the year are so flexible that spending will continue to increase during the next five years. These caps or ceilings allow for emergency spending increases as well as inflationary adjustments. However, nowhere in the bill is there an allowance for emergency tax cuts to stimulate the economy in a recession.

"Only $70 billion of this package are real reductions — reductions in Medicare, Federal Employee Retirement, Veterans programs, student loans and agriculture. New revenue increases outpace entitlement savings three to one."

In addition to their rubber-like flexibility, these caps will have no effect on IRS funding increases, credit re-estimates, Egyptian debt forgiveness, additional IMF contributions, emergency supplementals and Operation Desert Shield.

For all of these reasons, I believe the budget package fails the American people. It will fail their economic needs. It tries to lay the blame of the deficit and budget debacle at their feet. It tries to make them believe that the problem is not that Congress is spending too much — or that the government is wasting money — but that they are not being taxed enough. I don't believe it and neither do they. Treasury revenue has doubled in ten years — due to the economic boom provided by the tax cuts of 1981. Even that windfall wasn't enough for the big spenders.

"Under this so-called deficit reduction plan, total government spending will be $100 billion higher in 1991 than it was in 1990."

After this tax agreement, Americans have as much reason and right to rebel as they had in 1774

Tax Features

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Tax Foundation
470 L'Enfant Plaza, S.W.
Suite 7112
Washington, D.C. 20024
202-863-5454

U.S. Transfer Pricing Provisions Ignore Economic Realities of the 1990s

Richard M. Hammer

The complexity of U.S. tax provisions on foreign source income bedevils U.S. multinational firms. But when looking at American tax policy's problems in the foreign area, complexity is only the tip of the iceberg. Tax laws are changed without serious thought to the underlying tax policy; tax policies are not updated to the modern investment climate; and perceived tax law abuses are addressed with no regard to how the cure fits into the scheme of American foreign tax policy. What these problems really amount to is a failure by Congress, perhaps even a complete abdication of its responsibility for shaping a coherent and sensible foreign tax policy.

In this broad range of issues, I will focus on how U.S. transfer pricing rules affect domestic transactions, both inbound and outbound, even though the glare of recent publicity has been on the transfer pricing practices of foreign-owned companies bringing their products to the U.S.

From an overall policy perspective, the U.S. subscribes to the well-known "arms length" standard in transfer pricing. This generally keeps the U.S. in line with the rest of the world, most of whom adhere strictly to this standard. However, the U.S. has gradually reduced its dependence on true market evidence in establishing what is, or is not, arms-length. So far, these deviations from true market price have been restricted to narrow areas such as the safe-haven or administrative pricing formulae of the Domestic International Sales Corporation (DISC) and the Foreign Sales Corporation (FSC).

Recently proposals have been discusssed on Capitol Hill which would introduce a rigid 50/50 profit split on products shipped to U.S. distribution subsidiaries by foreign parents. This significant new deviation from the arms length standard would likely attract the attention of other nations. Earlier attempts to inject formulae into the transfer pricing process were more akin to facilitating the identification of an arms length transfer price, using what might be called a "rough cut approximation," rather than an overt attempt to reject the arms length standard.

The Tax Reform Act of 1986 (TRA'86) introduced the first major deviation from the arms length standard by adding the now infamous superroyalty provisions on intercompany transfer pricing on foreign transfers of intangible property rights. Unlike the earlier statutory formulary approach for profit allocation, the superroyalty provisions are subjective and, unfortunately, open-ended.

In a nutshell, superroyalty provisions require that payments on transfers of intangibles to related parties, either through the sale of an exclusive or non-exclusive license, must be "commensurate with the income attributable to the intangible." These deceptively simple words could be counter-productive economically and result in a nightmare when determining appropriate royalty adjustments.

Enacting the superroyalty provisions, Congress felt geographic rights to intangibles were being transferred to foreign affiliates before their full value was achieved in the United States. They considered this deleterious because the costs of developing the associated patent or "know how" were borne by and may have benefitted from the liberal U.S. R&D relief rules. If so, the revenues from the technology should accrue to the U.S. parent, not to the foreign affiliates which may have had little to do with developing the patent (used interchangeably with intangible).

In spite of opposition from American businesses having foreign affiliates, Congress insisted on passing the superroyalty rules. They will produce needless litigation, onerous compliance measures, and competitive impediments on American companies' ability to conduct trans-border transactions.

A White Paper issued to clarify the superroyalty provisions asserted that the "commensurate with income" standard applicable to foreign transfers of intangibles requires that periodic upward adjustments to royalties continue indefinitely into the future. Adjustments are mandated even if the arrangement was truly arms length when the contract was consummated. So if a U.S. multinational develops a new high-tech product, licenses it at arms length terms to foreign affiliates, and earns high profits because of foreign affiliates' efforts, the IRS would be free to increase royalty payments.

"If foreign tax authorities refuse tax deductibility for superroyalty payments, double taxation will result. Time will tell, but all indications to date are that foreign authorities are not going to roll over and play dead. Some will refuse simply because superroyalties are a breach of the arms length principle."

If foreign tax authorities refuse tax deductibility for superroyalty payments, double taxation will result. Time will tell, but all indications to date are that foreign authorities are not going to roll over and play dead. Some will refuse simply because superroyalties are a breach of the arms length principle. Such a scenario bodes especially ill for U.S. multinationals loaded down with excess foreign tax credits.

Shortcomings in the transfer pricing area epitomize congressional failure in the foreign tax area. The U.S. legislative focus appears to be primarily on generating revenue and closing tax loopholes. Such a myopic approach loses sight of the logical thread, the rhythm, that a sound tax policy and tax system require.

Richard M. Hammer, International Tax Partner, Price Waterhouse, is Chairman of the Tax Committee for the U.S. Council for International Business. This article is taken from his speech to the Foundation's international tax policy seminar September 25, 1990.

New Budget Raises Taxes Sharply; Hits States Unevenly

The new budget President Bush and congressional leaders have given the American people, touted as the grandest attempt at deficit reduction in history, will cost every man, woman, and child an average of $664.68 in new taxes over the next five years. Put another way, the agreement plans to extract $164.6 billion in extra revenue for the federal government by 1995.

The impact of the taxes will not be felt evenly from state to state (see map below). Many residents of states already paying among the highest per-capita federal tax burdens will have to fork over an even greater share. Connecticut, New Jersey, District of Columbia, and Massachusetts residents will face the largest per capita tax increases. While no state will escape unscathed, residents of Mississippi, Utah, and West Virginia will not be hit as hard. The additional per capita burdens range from a high of $869.76 in Connecticut to a low of $499.88 in Mississippi.

Why will some states have to pay more? Income levels and consumption patterns are the determining factors, so demographics dictate how much of the extra tax burden each state will bear. With over 42 percent of the new revenue coming from high-income individuals, states with relatively high personal incomes will be hard hit by the following provisions:

- the new 31 percent top income tax rate;
- the increase in the alternative minimum tax rate to 24 percent;
- the raising of the Medicare wage cap from $51,300 to $125,000;
- phase-out of personal exemptions for taxpayers with adjusted gross incomes above $100,000 (single taxpayer), $125,000 (head of household), and $150,000 (married, joint return);
- reduced itemized deductions (3 percent over $100,000);
- new 10 percent tax on luxury items.

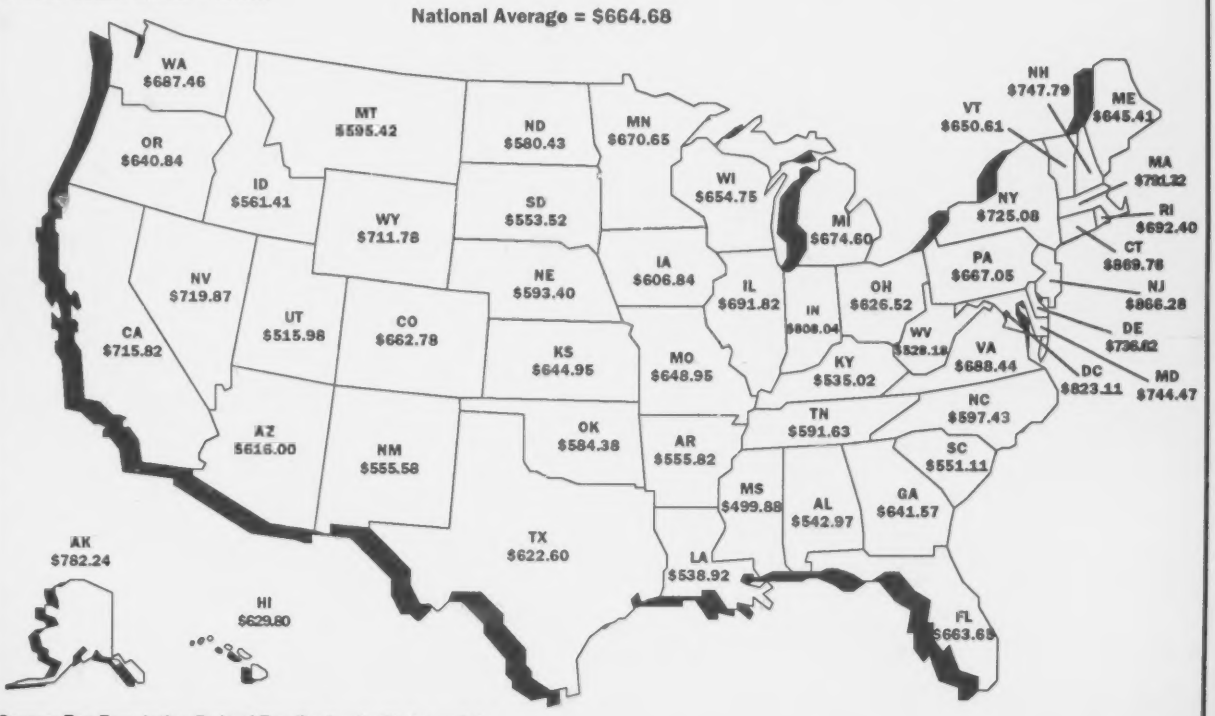
The budget includes comsumption taxes that generally hit low- and middle-income earners hardest. These will have a more dramatic impact on states with relatively low personal income levels. They include:

- the additional five cent per gallon motor fuel tax;
- the permanent extension of the telephone excise tax;
- the increase in the tobacco tax, an additional 8 cents by 1993;
- the increased taxes on beer, wine, and distilled spirits.

This year, the average American will spend 82 days working to pay his share of federal taxes. With $164.6 billion in guaranteed tax increases over the next five years, every American will be working longer for Uncle Sam, but some states will be shouldering a disproportionate share of the load.

New Budget's Additional Burden to Per Capita Federal Tax Burden State by State

Fiscal Years 1991 – 1995



Source: Tax Foundation Federal Tax Burden by State model

Median Family Income from page 1

since 1981. The family's earnings are eroded even further by indirect federal taxes, such as excises, and state and local taxes not shown here, all of which have been increasing sharply. Significant gains for the median family had been achieved in the mid-'80s, when income rose an average of $762 per year between 1982 and 1987.

The two-earner family that made $29,627 in 1980 is now earning an estimated $51,421. But this apparently hefty $21,794 increase in the family paycheck over ten years was slashed by direct federal taxes and inflation to a net gain of only $3,228. In other words, the sizable 73 percent nominal income gain the two-earner family has made since 1980 has been reduced to only a nine percent gain by direct federal taxes and inflation.

Federal Taxes

Since 1980, the federal income tax bill paid by the median family has risen 56.9 percent. As a percentage of the family's total income, the federal income tax claimed 13.7 percent of the family's total income in 1980, fell to a low of 11.8 percent in 1985, and rebounded to 12.4 percent in 1990.

The chunk that Social Security takes out of the typical family's income has increased more steadily. At $3,934 in 1990, it is more than double the $1,816 paid in 1980. Social Security will claim 7.6 percent of the family's 1990 earnings, up from 6.1 percent in 1980. Together, these two direct federal taxes will absorb 20 percent of family income, down only slightly from the 1981 peak of 20.3 percent.

Inflation

Rising inflation contributed to the decline in the typical family's purchasing power in 1990. Inflation stood at 13.5 percent in 1980 before declining steadily to a low of 1.9 percent in 1986, allowing the growth rate in family income to outpace inflation. Subsequently, however, inflation has accelerated and already has exceeded five percent in the first three quarters of 1990.

Proposed federal tax increases for FY1991, slowing of income growth, and the upswing in inflation do not bode well for the American family's purchasing power in the coming year.

See table at right for more detail on the plight of family income since 1980.

PRESIDENT'S MESSAGE

Average American Family Could Use a Break

Wayne Gable

In Lewis Carroll's *Through the Looking Glass,* Alice was told, "Now, here, you see, it takes all the running you can do to keep in the same place. If you want to get somewhere else, you must run at least twice as fast." Unfortunately, the predicament for America's median family in 1990 is even worse—as hard as the family has worked, taxes and inflation have thwarted its effort, lowering real income by $614. And this does not even include the state and local taxes and federal excise taxes the family has to pay on top of that.

Not that salaries have fallen. Indeed, the median family's income before federal taxes and inflation will rise an estimated $2,331 this year. But after higher income and Social Security taxes, along with rising inflation, that gain is just an illusion. The federal government has played its part in reducing the family's purchasing power by piling on higher taxes and simultaneously running up huge budget deficits that hinder economic growth.

Purchasing power's precipitous drop in 1990 is a bitter pill to swallow after a relatively prosperous decade for the median family. In the 1980s, 1981 was the only year that hurt family income more than this year, and aside from a slight downtick in 1988, every other year ended with greater family purchasing power. The mid-eighties were especially good, showing an average increase of $762 per year from 1982 to 1987.

The average family cannot look to the new budget for help. Many new taxes are included, and unless the general economy picks up the pace substantially, 1991 is likely to tell the same sad story as 1990.

We have redefined the median family as two earners working full time the year round with two dependents. Until the '80s, the one-worker family was more representative of the workforce, but the proportion of American families with two earners has increased to almost 70 percent. The stark reality now is that it takes two workers running twice as fast to get anywhere in today's high-tax environment.

Median Family Income Before and After Direct Federal Taxes and Inflation

1980-1990

Year	Two-Earner Median Family Income[a]	Direct Federal Taxes: Income Tax[b]	Direct Federal Taxes: Social Security	Direct Federal Taxes: Total	After-Tax Income: Current Dollars	After-Tax Income: 1990 Dollars[c]
1980	$29,627	$4,050	$1,816	$5,866	$23,761	$37,902
1981	32,224	4,386	2,143	6,529	25,695	37,155
1982	34,515	4,450	2,313	6,763	27,752	37,800
1983	36,106	4,300	2,419	6,719	29,387	38,781
1984	38,713	4,634	2,710	7,344	31,369	39,684
1985	40,593	4,787	2,862	7,649	32,944	40,243
1986	42,492	5,158	3,038	8,196	34,296	41,130
1987	44,536	5,291	3,184	8,475	36,061	41,724
1988	46,658	5,618	3,504	9,122	37,536	41,705
1989	49,090	6,022	3,687	9,709	39,381	41,744
1990[d]	51,421	6,357	3,934	10,291	41,130	41,130

[a] Median income for household with two earners employed full-time, year round.
[b] Married couple filing joint return, two dependent children.
[c] Adjusted by consumer price index, estimated 6% inflation in 1990.
[d] Estimate.
Source: Tax Foundation; U.S. Department of Commerce, Bureau of the Census; U.S. Department of Labor, Bureau of Labor Statistics; U.S. Treasury Department, Internal Revenue Service.

VIEWPOINT

Does the new FY1991 budget reconciliation plan provide a viable solution to the federal budget deficit problem without jeopardizing U.S. competitiveness?

William B. Modahl
Director of Tax Affairs
Digital Equipment

Months late and under election pressure, Congress finally passed its budget over the last weekend in October. The stock and bond markets were unimpressed by the news, in spite of Fed easing. This was not surprising because the federal government will still be draining capital markets by over $1 billion per day in new borrowing.

During the summit, the Bush administration went from "no new taxes" to "additional revenues in exchange for real spending cuts and budget process reform" to pretty much just more taxes. It was in many ways a repeat of recent slide-by summits, just with a higher price tag.

To avoid Gramm-Rudman's $85 billion sequester, $164.6 billion in new taxes were raised over the next five years. The much maligned bubble, which makes the code more progressive, was ironically used to promote "taxing the rich" and is now too politically convenient to give up. The so-called spending cuts do not take effect until FY 1993-94, after the 1992 elections—if in fact the cuts ever take place.

The Bush administration was faced with a choice: 1) negotiate a package with Congressional Democrats, reneging on the "no new taxes" pledge, or 2) veto appropriations bills, and force negotiations in the context of a Gramm-Rudman sequester. President Bush chose alternative 1. With the benefit of hindsight, it is hard to believe the political cost of the second course could have been greater.

"It was in many ways a repeat of recent slide-by summits, just with a higher price tag."

Of course, we do need to reduce the deficit. What has been forgotten is that it matters whether we do it by cutting spending or raising taxes. An excessive focus on deficits has caused us to lose sight of the real issue — economic growth.

In reviewing the drama of the 1991 budget, one is reminded of George S. Kaufman's comment: "I didn't like the play, but then I saw it under adverse circumstances — the curtain was up." Unfortunately, we may have to sit through many reruns. With the pledge broken and taxes raised once, we are now likely to face a series of annual tax increases to "reduce the deficit," that is, fill in behind spending growth as the government preempts a growing share of the nation's income.

It depends on whether Congress and the Administration adhere to the spending targets. If they won't do it now, what reason is there to think they will do it in the future?

Albert E. Germain
Vice President, Taxes
ALCOA

The most positive thing about the recent budget agreement is that "finally it's over for another year."

It's an historic first—a 5-year package of spending cuts and tax increases, which avoided further increases in corporate tax rates, avoided further burdens on private employee-benefit plans, and even avoided complicating an already bizarre set of foreign tax rules.

It helped level the global playing field slightly by imposing tax information return requirements on foreign firms doing business in America, much like the returns filed each year by American firms. But, it will certainly further confuse our competitive position by imposing the threat of harsh new tax penalties in an area already subject to much confusion, namely, intercompany pricing.

Unfortunately, there were also some ominous features to this budget process. A "new tax environment of the '90s" has previewed, with societal life-threatening "myths and red herrings."

Apparently some Americans still feel they have the right to benefit from government expenditures without sharing any increased costs—sort of a "new free lunch."

While Medicare recipients "demand" no increase in their costs (it was intended to be 50/50 co-pay from the start), the younger generation dutifully pays the highest social security tax in our history.

While more successful Americans are vilified on nightly TV for not paying enough tax (but Tax Foundation figures show that 46 percent of all income taxes are paid by the top 5 percent), the average American is featured as refusing to pay a few extra pennies in gas tax to help reduce the enormous federal debt he helped run up.

Although the recent package is a first step, my biggest worry is "what do we do next?" Our most urgent national fiscal issue is mustering enough social and political "spunk" to address the deficit crisis with "broad-based cures" that fairly and evenly distribute the "pain."

I firmly believe that under the leadership of George Bush, and with the cooperation of Congress, America can meet this challenge.

Viewpoint *brings concise opinions from experts in tax and fiscal policy to the readers of* Tax Features *on questions that are currently being debated by policymakers and the media. The opinions expressed are not necessarily those of the Tax Foundation. Editorial replies are encouraged.*

Public Finance in Crisis:

Meeting the Challenge

Tax Foundation's 42nd National Conference and 53rd Annual Dinner

Wednesday, December 5, 1990 at The Waldorf-Astoria Hotel in New York City

Registration/Light Fare	**12:30 p.m.**	**Astor Salon/Foyer**
Conference Sessions	**1:00 – 5:00 p.m.**	**Astor Salon**
Reception & Dinner (Black tie optional)	**6:00 p.m.**	**Palm Room/Starlight Room**

- Direct any questions about the conference or dinner to Dixie Reding at 202-863-5454. FAX 202-488-8282.
- Reservations should be received by Wednesday, November 28, 1990.
- The Waldorf-Astoria is located at 301 Park Avenue, New York, NY 10022. Tel: 212-871-4534.

12:30 Registration (light fare)

1:00 Welcome: Wayne Gable
President, Tax Foundation

The Ailing Federal Budget Process: Is There a Cure?

Issue Overview: Allen Schick
Professor of Public Policy
University of Maryland

Chairman: Alan Blinder
Gordon S. Rentschler Memorial Professor of Economics
Princeton University

James C. Miller III
Director, OMB for President Reagan, 1985 - 1988
Co-Chairman, Tax Foundation

David Stockman*
Director, OMB for President Reagan, 1981 - 1985
Partner, The Blackstone Group

James McIntyre, Jr.
Director, OMB for President Carter, 1977 - 1981
Partner, McNair Law Firm, P.A.

3:00 Coffee Break

3:15 ***Significant Trends in State and Local Taxation***

Chairman: Haskell Edelstein
Senior Vice President and General Tax Counsel
Citicorp/Citibank, U.S.A.

James W. Wetzler
Commissioner
New York Department of Revenue and Finance

Benjamin F. Miller
Counsel, Multistate Tax Affairs
California Franchise Tax Board

David R. Francis
Business Editor
Christian Science Monitor

Thomas B. Joyce
Partner, Washington National Tax Services
Price Waterhouse

5:00 Adjournment

*Not confirmed

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Tax Foundation
470 L'Enfant Plaza, S.W.
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Attn: Dixie Reding

Conference Fee: Member/$100, Non-Member/$125 Dinner/Reception: $250

For the attendees listed, a check made payable to the **Tax Foundation** in the amount of $_____ is enclosed.

Briefings in Los Angeles and San Francisco Bring Foundation's Message to West Coast

▲ *From left to right at the headquarters of Occidental Petroleum in Los Angeles: Host Norman D. Alexander, Vice President - Corporate Affairs, Occidental Petroleum; Clayton J. LaForce, Dean, UCLA Graduate School of Business; Maureen Reagan; James C. Miller III, Co-Chairman, Tax Foundation; Paul C. Hebner, Executive Vice President, Occidental Petroleum; and Wayne Gable, President, Tax Foundation.*

Hosted by Chevron Corporation at the World Trade Club in San Francisco: (L to r.) J.P. LaCasse, Director of Taxes, American President Companies; Hugh Travaille, Vice President - Public Affairs, Potlatch Corporation; Steven L. Rosner, Manager - Tax Accounting, Pacific Telesis Group; James C. Miller III, Co-Chairman, Tax Foundation; Glenn White, Co-Chairman, Tax Foundation Program Committee; and Christine Smith-Annello, Manager - Tax Planning, Levi Strauss & Co. ▼

◀ *From left to right at Occidental: Wayne Gable, President, Tax Foundation; Debra A. Gastler, Vice President - Taxes, Pacific Enterprises; and Anthony H. Buckman, Corporate Tax Manager, Toyota, U.S.A.*

In San Francisco: (L to r.) John J. Ross, General Tax Counsel, Chevron; James C. Miller III, Co-Chairman, Tax Foundation; and Martin R. Klitten, Vice President of Finance, Chevron. ▶

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See page 7 for information on the Tax Foundation's Annual Conference and Dinner December 5th at the Waldorf-Astoria Hotel in New York City